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C O N F I D E N T I A L SECTION 01 OF 02 TAIPEI 000875

SIPDIS

STATE PLEASE PASS AIT/W AND USTR
STATE FOR EAP/RSP/TC, EAP/EP AND EB/IFD/OIA
USTR FOR SCOTT KI
USDOC FOR 4420/USFCS/OCEA/EAP/LDROKER
USDOC FOR 3132/USFCS/OIO/EAP/ADAVENPORT
TREASUREY FOR OASIA/LAILEE MOGHTADER
TREASURY PLEASE PASS TO OCC/AMCMAHON
TREASURY ALSO PASS TO FEDERAL RESERVE BOARD OF GOVERNORS,
AND SAN FRANCISCO FRB/TERESA CURRAN

E.O. 12958: DECL: 03/01/2025
TAGS: [EINV](#) [EFIN](#) [ECON](#) [PINR](#) [TW](#)
SUBJECT: RAPID TAIWAN DOLLAR APPRECIATION

Classified By: AIT ACTING DIRECTOR DAVID KEEGAN, REASON 1.5 B/D

11. (SBU) The Taiwan dollar (NTD) in heavy trading on March 2 broke the NTD 31/USD 1 barrier for the first time since 2000, having appreciated by about 10 percent against the US Dollar (USD) since mid-2004. The NTD will face even more appreciation pressure as fund managers bring in capital in expectation of further appreciation and in response to the Morgan Stanley Capital International Company increase in its limited investability factor (LIF) index for Taiwan from 0.75 to 1.00, scheduled for May 2005. Taiwan's central bank continues to keep about three-quarters of its foreign exchange in USD-denominated assets, a share unchanged in the past year. END SUMMARY.

Drastic Appreciation

12. (SBU) The NTD broke the NT\$31-per-USD point to close the morning of March 2 at NT\$30.879 per USD. The trading volume was US\$2,059 million, the sixth largest ever. The NTD has appreciated nearly ten percent since the middle of 2004. In the first two months of 2005, the NTD has gained 2.8% against the USD, less than Korean Won's appreciation of 3.1%. However, in the same two-month period, the Japanese Yen and the Euro have depreciated 1.63% and 2.55% against the USD, respectively.

NTD to Continue Appreciation

13. (C) The NTD will continue to gain strength as foreign portfolio investors send capital into Taiwan in anticipation of further appreciation and to be ready for the upward adjustment of the Morgan Stanley LIF index from 0.75 to 1.00 scheduled for May 2005. Alex Pan, a senior foreign exchange trader of the Bank of America, told AIT/T that foreign portfolio investors usually start to send capital into a market two or three months prior to such an adjustment to take advantage of the projected increase in stock prices. Huang Wen-jur, a senior consultant of the SinoPac Securities Company (SSC), noted that the NTD appreciated from NT\$34 per USD to NT\$32.9 per USD three months before Morgan Stanley raised the LIF from 0.55 to 0.75 in early November 2004. During the three-month period, foreign portfolio investors sent US\$7.94 billion of funds into Taiwan. In the subsequent eight trading days, foreign portfolio investors posted net stock purchases of NT\$57 billion.

Central Bank Response to Hedge Funds

14. (C) Officials at Taiwan's central bank (CBC) suspect the recent rapid appreciation of the NTD and Korean won against the USD has been partly the result of hedge fund attempts to force appreciation of those currencies. The SSC's Huang Wen-jur told AIT/T that large sums of capital from foreign mutual funds was currently "waiting on the sidelines" of Taiwan's stock markets. Director General of the CBC Foreign Exchange Department George Chou told AIT/T that the amount of foreign funds brought into Taiwan for the stated purpose of trading in securities, but not invested, had reached as high as NT\$260 billion. He said these funds do not earn any interest rate from Taiwan's bank accounts but are likely earning 2-4% from their deposit in European and U.S. banks. Chou said he believed these funds would be pulled out of Taiwan without any securities trading after earning foreign exchange gains from the expected NTD appreciation. Vice Premier Wu Rong-yi and Chia-hsin Cement President Chang An-ping told AIT/ADIR in a conversation on March 2 that they expected to see continued appreciation of the NTD within the next three to six months.

15. (C) After CBC analysts became aware of the huge scale of these "not-invested" funds brought into Taiwan, Director

General Chou met with local and foreign fund managers to request that they pull the funds out of Taiwan if the money was not being used to trade in securities, as stated in the inward remittance statements. According to Chou, CBC Governor Peng Fai-nan (Peng Haui-nan) has proposed restricting foreign mutual funds from leaving Taiwan if such funds have not been used to trade in securities. (Chou said this proposal was modeled on a South Korean restriction on foreign mutual funds.) However, Kong Jaw-sheng, Chairman of the Financial Supervisory Commission (FSC), opposed the restriction, in part because this would cause the speculative funds to flow in the stock market, inflating stock prices in the short run, and setting the stage for price falls when the funds are withdrawn after the currency appreciates. Chou said that in the end, the CBC and the FSC agreed to work together to closely monitor the movement of foreign mutual funds to prevent manipulation of the NTD exchange rate.

Foreign Exchange Reserves

16. (SBU) As a result of foreign capital inflows and Taiwan's trade surplus, Taiwan's foreign exchange reserves in December 2004 increased to US\$241.7 billion, up from US\$206.6 billion at the end of 2003. Taiwan's reserves are continuing to build in response to the influx of foreign portfolio investments.

17. (C) In speaking with AIT, Director General Chou denied a recent local press report that the CBC had sold USD-denominated assets from Taiwan's foreign exchange reserves. According to Chou, USD-denominated assets are still 74.5% of Taiwan's total foreign exchange reserves, and the percentage has remained unchanged over the past year. He indicated however that the CBC occasionally changed the composition of Taiwan's foreign exchange reserves by moving from one USD-denominated asset to another as a part of "financial management." Consequently, a foreign bank holding a portion of the reserves may see a decline in a certain type of USD-denominated assets. According to Mr. Chou, 22% of the CBC's foreign exchange reserves are denominated in Euros and the remaining 3.5% in Japanese Yen and Pound Sterling.

18. (C) According to the Chunghua Institute for Economic Research the appreciation of the NTD could significantly slow Taiwan's real economic growth in 2005 to 2.6%, down from the 4.6% forecast earlier as investment and production in Taiwan becomes more expensive relative to offshore production. However, an economist from another institute cynically noted to AIT that most Taiwan manufacturers in a position to consider offshore production have already left Taiwan.

19. (C) Comment: Hedge funds, "hot" money, and ordinary investors are looking to take advantage of the expected continued appreciation of the NTD. We anticipate that central bank and security regulators will indeed keep a close watch on fund flows into Taiwan but note the risk that the large volumes of capital being moved into Taiwan may create instabilities in the financial sector beyond the ability of the regulators to control. End comment.

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